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## Regaining Trust in Nonprofit Charter Schools: Toward Benefit Corporation Branding for For- Profit Education Management Organizations

James Eastman

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# REGAINING TRUST IN NONPROFIT CHARTER SCHOOLS: TOWARD BENEFIT CORPORATION BRANDING FOR FOR-PROFIT EDUCATION MANAGEMENT ORGANIZATIONS

The point is, ladies and gentleman, that greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms—greed for life, for money, for love, knowledge—has marked the upward surge of mankind. And greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the USA. Thank you very much.<sup>1</sup>

– The infamous stock-trading mogul, Gordon Gekko, in the movie *Wall Street*.

## I. INTRODUCTION: THE CURRENT AMERICAN NONPROFIT CHARTER SCHOOL LANDSCAPE

Since the first charter school opened in Minnesota in 1991, the political and educational spheres have enshrined charter schools in positive rhetoric, hailing them as “laboratories of innovation.”<sup>2</sup> Encouraging charter school creation is one of the cornerstones of the Obama Administration’s “Race to the Top” program, and this support is similarly reflected in federal and state legislatures.<sup>3</sup> Notwithstanding conflicting studies assessing charter school effectiveness as compared to traditional public schools, it is clear from the annually

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<sup>1</sup> WALL STREET (20th Century Fox 1987).

<sup>2</sup> Susan L. DeJarnatt, *Follow the Money: Charter Schools and Financial Accountability*, 44 URB. LAW. 37, 38 (2012).

<sup>3</sup> See Paul Manna & Laura L. Ryan, *Competitive Grants and Educational Federalism: President Obama’s Race to the Top Program in Theory and Practice*, 41 PUBLIUS: J. FEDERALISM 522, 527 (2011) (Under Obama’s “Race to the Top” program, “one specific criterion awarded up to forty points for states that had created conditions to promote the development of high-performing public charter schools and other innovative schools. The weighting clearly favored charter schools, though, because if a state had many policies to promote different alternatives except charter schools then the most it could earn on this criterion was eight points.”). See also DeJarnatt, *supra* note 2, at 38.

increasing number of charter schools coupled with federal and state backing that charter schools are here to stay.<sup>4</sup>

Despite the optimistic affirmation that charter schools receive, the nonprofit charter school movement has recently come under intense government and media scrutiny.<sup>5</sup> This has been spurred by scandals involving education management organizations (“EMOs”), which some nonprofit charter schools hire to operate their charter schools wholly or in part.<sup>6</sup>

The scrutiny began when the growing number of nonprofit charter schools caught the private sector’s attention several years ago. Venture capital firms and hedge fund managers began to view nonprofit charter schools as a “largely untapped and potentially lucrative market.”<sup>7</sup> This raised an interesting question: why did venture capital firms and hedge fund managers find nonprofit charter schools so attractive as a

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<sup>4</sup> See Elaine Liu, *Solving the Puzzle of Charter Schools: A New Framework for Understanding and Improving Charter School Legislation and Performance*, 2015 COLUM. BUS. L. REV. 273, 285–89 (2015). While it is not this Note’s purpose to evaluate whether charter schools deliver superior education to public schools, it is worth noting that there are many conflicting studies assessing charter school effectiveness. Several studies have seriously questioned the premise that charter schools employ innovative teaching methods both more effectively and more often than public schools. What is certain though, is that much like in public schools, student performance varies significantly between charter schools in the same states and across different states.

<sup>5</sup> John Morley, *For-Profit and Nonprofit Charter Schools: An Agency Costs Approach*, 115 YALE L.J. 1782, 1795 (2006). Scholars and the public sometimes conflate a charter school’s entity choice, such as being a nonprofit versus for-profit entity, with a third-party contractor’s form, and then refer to the charter school as a nonprofit or for-profit based on the contractor’s form. This is incorrect because sometimes the charter school is a nonprofit that holds the school’s charter and manages its own running. But sometimes nonprofit charter schools hold the charter, but then contract with an external contractor or business to run a substantial part of the school. In the United States, charter schools, also known as charter holders, can be nonprofit or for-profit institutions. However, a majority of charter schools are nonprofits because many states’ laws dictate whether a charter school must be a nonprofit. Then, if a charter school contracts with a vendor or business, that business can be a for-profit or nonprofit organization itself. And again, there are sometimes state laws regulating whom a charter school can contract with. This Note will focus on nonprofit charter schools because the issues addressed solely affect nonprofit charter schools.

<sup>6</sup> See Kathleen McGrory, *South Miami-Based Charter School Management Company Under Federal Scrutiny*, MIAMI HERALD (April 20, 2014, 9:51 AM), <http://www.miamiherald.com/news/local/community/miami-dade/article1963142.html> Florida’s largest charter school management company came under federal scrutiny after an audit report identified “potential conflicts of interest between the for-profit company Academica and the Mater Academy charter schools it manages. One example the auditors cited was the transfer of money from Mater Academy to its private support organization, which shares the same board of directors.” *Id.*

<sup>7</sup> F. Howard Nelson, *What Does Private Management Offer Public Education?*, 11 STAN. L. & POL’Y REV. 271, 272 (2000).

means of raising capital when, in return for favorable tax treatment, nonprofit charter schools are prohibited from having shareholders or distributing profits?<sup>8</sup> The answer came when the private sector started funding for-profit EMOs to contract with and operate nonprofit charter schools.<sup>9</sup> Funding EMOs to contract with charter schools had the effect of diverting the state and federal government funding nonprofit charter schools received into EMO coffers, which then ended up in the private sector's pockets.<sup>10</sup> The private sector can access state funding reserved for public education raised through taxes because although many states mandate that charter schools must be nonprofits, there is often no legislation precluding nonprofit charter schools from contracting with and paying for-profit organizations for educational services with their public funding.<sup>11</sup> Investing in EMOs became such a profitable business that firms began providing courses in how to best privatize charter school education, such as a master class taught by Capital Roundtables called "Private Equity Investing in For-Profit Education Companies."<sup>12</sup> Further, the federal "New Markets Tax Credit" program under the Clinton administration gave businesses that invest in charter schools in "underserved" areas a 39% tax credit to offset costs, incentivizing investing in charter schools and EMOs.<sup>13</sup>

Some EMOs have since taken a page out of Gordon Gekko's book of greed and have been accused of engaging in fraudulent activities; nonprofit charter school operators have set up for-

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<sup>8</sup> Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

<sup>9</sup> Kathleen Conn, *When School Management Companies Fail: Righting Educational Wrongs*, 31 J.L. & EDUC. 245, 253 (2002).

<sup>10</sup> *Id.* ("[W]hen state charter school laws allow large for-profit corporations to manage schools, or when nonprofit managers contract with for-profit companies to provide educational services, the specter of for-profit companies misappropriating tax dollars is especially frightening.")

<sup>11</sup> See e.g., FLA. STAT. § 1002.33 (2011); GA. CODE ANN. § 20-2-2065(b)(1) (States such as Florida and Georgia are either completely silent on whether charter schools may contract with EMOs, or explicitly allow for them to do so).

<sup>12</sup> Kristin Rawls, *Who is Profiting From Charters? The Big Bucks Behind Charter School Secrecy, Financial Scandal and Corruption*, ALTERNET (May 8, 2013), <http://www.alternet.org/education/who-profiting-charters-big-bucks-behind-charter-school-secrecy-financial-scandal-and>.

<sup>13</sup> Addison Wiggin, *Charter School Gravy Train Runs Express to Fat City*, FORBES (Sep. 10, 2013, 5:31 PM), <http://www.forbes.com/sites/greatspeculations/2013/09/10/charter-school-gravy-train-runs-express-to-fat-city/#3e9312b270e5>.

profit EMOs to extract and distribute their charter school's operating profits.<sup>14</sup> Another instance of EMOs abusing charter school funding occurred when EMOs began redirecting funds allocated to teacher salaries and resource development to charge charter schools inflated rent for their facilities.<sup>15</sup> While EMOs manage only approximately 15% of all American nonprofit charter schools, the negative effects that a few EMOs have had on the charter schools they manage have cast a shadow over the charter school movement and other for-profit EMOs that help charter schools without harming them.<sup>16</sup> The actions of the EMOs involved in scandals are at great odds with their professed goal of “shap[ing] a world in which every student, regardless of socioeconomic circumstance, has access to an excellent education.”<sup>17</sup>

Charter school exploitation has become such a problem that the New York State Legislature revised the state's Charter Schools Act in May 2010 to prohibit EMOs from contracting with charter schools.<sup>18</sup> Charter schools that contracted with EMOs prior to the change were allowed to continue their association.<sup>19</sup> New York revised its charter school statute because although only a small portion of the state's charter schools had partnered with EMOs, the bad press that a few EMO-charter school affiliations created detracted from much of the positive work that many EMO- and non-EMO-managed

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<sup>14</sup> Emma Brown, *D.C. Officials Seek Stronger Oversight of Charter Schools After Recent Fraud Allegations*, WASH. POST (June 15, 2014), [https://www.washingtonpost.com/local/education/dc-officials-seek-stronger-oversight-of-charter-schools-after-recent-fraud-allegations/2014/06/15/fb5e1042-f0b4-11e3-bf76-447a5df6411f\\_story.html](https://www.washingtonpost.com/local/education/dc-officials-seek-stronger-oversight-of-charter-schools-after-recent-fraud-allegations/2014/06/15/fb5e1042-f0b4-11e3-bf76-447a5df6411f_story.html); Morley, *supra* note 5, at 1789 (Charter school operators are those who apply to the relevant state agency for a charter, and once approved, hold the charter).

<sup>15</sup> Catherine Candisky, *Charter School's Lease Deals Scrutinized*, COLUMBUS DISPATCH (Oct. 12, 2014, 10:10 AM), <http://www.dispatch.com/content/stories/local/2014/10/12/charters-lease-deals-scrutinized.html>.

<sup>16</sup> NATIONAL ALLIANCE FOR PUBLIC CHARTER SCHOOLS, A CLOSER LOOK AT THE CHARTER SCHOOL MOVEMENT 8 (2016) <http://www.publiccharters.org/wp-content/uploads/2016/02/New-Closed-2016.pdf> (hereinafter “NATIONAL ALLIANCE”).

<sup>17</sup> *Mission*, EDISON LEARNING, <http://edisonlearning.com/mission.php> (last visited June 8, 2016).

<sup>18</sup> N.Y. EDUC. LAW § 2851(1).

<sup>19</sup> NEW YORK CITY CHARTER SCHOOL CENTER, THE PROFIT MYTH: UNDERSTANDING THE STRUCTURE OF NEW YORK CHARTER SCHOOLS 6 (Sept. 2011), [http://www.nycharterschools.org/sites/default/files/resources/charter\\_school\\_profit\\_myth.pdf](http://www.nycharterschools.org/sites/default/files/resources/charter_school_profit_myth.pdf).

charter schools had accomplished.<sup>20</sup> In order to make sure that state education funding went to improving student education instead of for-profit EMO operators, other states have also banned charter schools from partnering with EMOs, including New Mexico, Washington, Connecticut, and Mississippi.<sup>21</sup> Further, some charter schools have had to shut down because of EMO mismanagement, and these closures severely disrupted the education process for students.<sup>22</sup> Parents then often enrolled their children in traditional public schools, causing an overcrowding problem that the now shuttered charter schools were meant to alleviate in the first place.<sup>23</sup>

While there is support for states forbidding charter schools from contracting with EMOs, there are arguments in favor of allowing them to continue contracting with EMOs.<sup>24</sup> For example, EMOs often have greater managerial control over a charter school's internal operations, and EMOs have the capital required to invest in research and develop innovative teaching methods that their traditional public school counterparts often lack.<sup>25</sup> However, the foremost reason that a party operating a new charter school hires an EMO is that the party often lacks sufficient experience in school management.<sup>26</sup> Thus EMOs may remain an important component of the charter school movement as they offer new charter school operators the expertise and resources required to get a charter school off the ground.<sup>27</sup>

There is tension between states allowing EMOs to continue providing charter schools with beneficial expertise and the need to prevent the damage that some EMOs have caused by

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<sup>20</sup> *Id.* at 5 (By 2011, 9% of the 185 charter schools in New York state had contracted with EMOs.).

<sup>21</sup> See CONN. GEN. STAT. ANN. § 10-66aa (West 2016); MISS. CODE ANN. § 37-28-39 (West 2017); N.M. STAT. ANN. § 22-8B-4 (West 2017); 2016 WASH. LEGIS. SERV. CH. 241 (E.S.S.S.B. 6194) (West).

<sup>22</sup> See Conn, *supra* note 9, at 249.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> GUILBERT C. HENTSCHE ET AL., TRENDS & BEST PRACTICES FOR EDUCATION MANAGEMENT ORGANIZATIONS 5–6 (2003) [https://www.wested.org/online\\_pubs/PP-03-02.pdf](https://www.wested.org/online_pubs/PP-03-02.pdf).

<sup>26</sup> Julia Davis, *Contracts, Control and Charter Schools: The Success of Charter Schools Depends on Stronger Nonprofit Board Oversight to Preserve Independence and Prevent Domination by For-Profit Management Companies*, 2011 BYU EDUC. & L.J. 1, 8 (2011).

<sup>27</sup> *Id.* (For example, EMOs are better able to negotiate discounted prices for school supplies).

exploiting charter schools. The approach some states have taken is to bar EMOs completely from contracting with charter schools, and this tactic threatens EMOs' continuing existence.<sup>28</sup> Other states have walked a middle ground by appointing independent charter school review boards to oversee charter schools.<sup>29</sup> But some argue that adding additional levels of bureaucracy in the chartering process may interfere with the original intent behind charter school proliferation—namely, charter school autonomy and innovation.<sup>30</sup> Increasing legislative hostility toward EMOs means that if offending EMOs do not change their ways, the focus of the EMO business model will change. EMOs will no longer be able to focus on developing innovative teaching methods that will improve student performance and lead to contract renewal.<sup>31</sup> Instead, their chief concern will be stopping state legislatures from preventing contracts with charter schools altogether because a few EMOs have engaged in questionable business practices.

Poor student performance in EMO operated charter schools has resulted in charter school closures. However, failure to improve charter school education is not the main reason why states are reconsidering EMO-charter school affiliations. Gross financial mismanagement, difficulty tracking how taxpayer money is spent once it moves from the charter schools into EMOs, and fraudulent activities are fueling the legislative backlash against EMOs in states like New York.<sup>32</sup> This Note

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<sup>28</sup> See Kathleen Conn, *For-Profit School Management Corporations: Serving the Wrong Master*, 31 J.L. & EDUC. 129, 147 (2002) (“The surest way to abolish the conflict inherent in the corporate paradigm of shareholder wealth maximization and using corporate funds to provide the best possible education for students is to prohibit for-profit corporations from managing schools.”).

<sup>29</sup> Arianna Prothero, *More States Create Independent Charter Approval Boards*, EDUCATION WEEK (Aug. 19, 2014), <http://www.edweek.org/ew/articles/2014/08/20/01authorizers.h34.html>.

<sup>30</sup> *Id.*

<sup>31</sup> See Conn, *supra* note 28, at 146 (“In most school privatization contracts, the school district engages the management corporation, turns over the reins of the school system, and expects improvement in school district finances and in students' educational performance. If the expected results do not materialize, the school district can ‘fire’ the managers and resume control.”).

<sup>32</sup> See Conn, *supra* note 9, at 249 (“However, mismanagement, loss of building leases, and failure to provide promised educational programs also caused closures.”); Marian Wang, *When Charter Schools are Nonprofit in Name Only*, PROPUBLICA (Dec. 9, 2014, 11:49 AM), <https://www.propublica.org/article/when-charter-schools-are-nonprofit-in-name-only> (“Regulators in the District of Columbia are seeking more legal authority over management firms after two recent scandals. The DC Public Charter School Board has asked the city council to pass legislation that would allow access to

does not seek to evaluate how successful for-profit EMOs are at improving the charter schools they work with, because “no state has analyzed student achievement in charter schools managed by private managers separately from other charter schools.”<sup>33</sup> Given current projections concerning the prominence of EMO and charter school partnerships, nonprofit charter schools will continue contracting with for-profit EMOs, regardless of performance results, as long as the individual states allow these relationships.<sup>34</sup> As such, this Note will argue that EMOs are potentially valuable to the nonprofit charter school movement. EMOs that provide these benefits need to operate in a way that generates profit while avoiding scandal, which harms their public perception, because both have a great deal to offer in terms of bringing education to at-risk children.<sup>35</sup> This Note will concentrate on what EMOs can do to regain the trust of state legislatures so that they are not banned from contracting with charter schools.

This Note suggests that moving forward, EMOs should choose to be “benefit corporations” as opposed to traditional C-Corps, and to re-brand themselves as such. The benefit corporation is a new hybrid entity that allows a corporation to balance the traditional shareholder wealth maximization norm that corporations generally follow with making decisions that advance a general public benefit.<sup>36</sup> In the case of EMOs, their general public benefit would be providing nonprofit charter schools with resources and expertise in exchange for fees. By adopting the benefit corporation brand, EMOs can show state legislatures that they are capable of balancing profit-making prerogatives while benefiting nonprofit charter schools that hire them. Benefit corporation statutes hold benefit corporations accountable via two devices: independent third-party evaluators and internal enforcement proceedings.<sup>37</sup> Implementing these measures would allow states to avoid

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the books of management companies under certain conditions. So far, the effort has gone nowhere.”)

<sup>33</sup> Nelson, *supra* note 7, at 281.

<sup>34</sup> Gary Miron, *Profiles of For-Profit and Nonprofit Education Management Organization*, NATIONAL EDUCATION POLICY CENTER 5 (2013), <http://nepc.colorado.edu/files/emo-profiles-11-12.pdf>.

<sup>35</sup> Liu, *supra* note 4, at 294.

<sup>36</sup> Felicia R. Resor, *Benefit Corporation Legislation*, 12 WYO. L. REV. 91, 106–07 (2012).

<sup>37</sup> *Id.* at 106–09.



adding new bureaucratic layers of charter school oversight, thus saving state resources and allowing charter schools to maintain their original autonomy.<sup>38</sup>

While the potential for a decrease in both profits and new potential investors may make some EMOs hesitant to become benefit corporations, there is evidence that acting in a socially responsible way may actually increase a business's profits and attract investors who want to make a profit but also want their money used in conscientious ways.<sup>39</sup> Further, it may be more advantageous for EMOs to be socially responsible than to risk states following in New York's footsteps and banning them entirely, which would have a greater negative affect on an EMO's profits.<sup>40</sup>

This Note proceeds in four parts. Part II lays out the background necessary for understanding why charter schools exist and their importance in improving American public education. This Part will provide an overview of the nonprofit charter school system, including the historical backdrop against which states passed charter school legislation, how charter schools operate, and the benefits that charter schools provide.

Part III explains EMOs, including their function, their association with the charter school movement, and the benefits and drawbacks of EMOs contracting with charter schools. This Part then explores in detail why EMOs are the center of many nonprofit charter school scandals and how these scandals have resulted in some states banning EMOs from contracting with charter schools. The Part will examine several instances where charter schools and EMOs have been investigated for a lack of transparency as to how EMOs spend public funding and for charging charter schools inflated rent.

Part IV introduces the benefit corporation. This Part will argue that by rebranding themselves as benefit corporations, EMOs can continue to profit from the public education sector while not making choices that mismanage charter school funding. First, this Part will explain the key characteristics of the benefit corporation entity by comparing the model approach to benefit corporations against the Delaware approach. Next,

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<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 110.

<sup>40</sup> Wang, *supra* note 32.

this Part will explore how becoming a benefit corporation will advance EMOs both by preventing states from banning them from contracting with charter schools, and by helping them attract investors and potential shareholders.

Part V will conclude the Note, arguing that EMOs should not follow the path of Gordon Gekko's greed speech, and should instead embrace the benefit corporation and regain the trust of the states, remain open, and help charter schools.

## II. BACKGROUND: AN OVERVIEW OF THE UNITED STATES CHARTER SCHOOL SYSTEM

### *A. The Historical Underpinnings that Lead to Individual States Passing Charter School Legislation*

While the Supreme Court does not recognize education as a fundamental right, the Supreme Court agreed that education was nonetheless of "undisputed importance."<sup>41</sup> Since *Brown v. Board of Education*, the Supreme Court charged state and local governments with the important task of monitoring and advancing education.<sup>42</sup> With the Supreme Court placing this responsibility on the individual states, state governments scrambled to improve their education systems.<sup>43</sup> However, as of August 2015, 92% of Americans reported being less than totally satisfied with the education that students receive in kindergarten through grade twelve ("K-12"), and by extension, less than satisfied with the efforts of their respective states in the education arena.<sup>44</sup> This admittedly high statistic is not a recent trend.<sup>45</sup> In fact, America's lack of total satisfaction with K-12 education has lingered between 90 and 93% since August 1999, and this trend likely extends back many years.<sup>46</sup> In response to dissatisfaction among parents over the lack of education options, quality, and diversity in K-12 education, states began passing legislation granting "independent school operator[s]" the ability to create charter schools while placing

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<sup>41</sup> *San Antonio Indep. Sch. Dist. v. Rodriguez*, 411 U.S. 1, 35 (1973).

<sup>42</sup> *Brown v. Bd. of Ed. of Topeka*, 347 U.S. 483, 493 (1954) ("[E]ducation is perhaps the most important function of state and local governments.").

<sup>43</sup> *Education Poll*, GALLUP, <http://www.gallup.com/poll/1612/Education.aspx> (last visited June 2, 2016).

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

few restrictions on who could start one.<sup>47</sup>

The charter school concept is based on Milton Friedman's free market theories, which posit that allowing parents their choice of schools would promote competition between charter school operators and traditional public school operators.<sup>48</sup> A more competitive education market would theoretically be "more innovative, responsive, and efficient than government-run education 'monopolies.'"<sup>49</sup> This is as opposed to the then-dominant Keynesian economic model, which stressed that the government, and not the free market, should guide the allocation of capital and resources in education.<sup>50</sup>

### B. Charter School Structure and Procedures

Until 1991, parents had three options for their children's education: private school, traditional public school, or homeschool. In 1991, Minnesota became the first state to pass charter school legislation, introducing a fourth education option that promised to satisfy parental and state demand for higher quality and more diverse K–12 education.<sup>51</sup> While charter schools are technically public schools because they receive state and federal funding, it is important to distinguish them from traditional public schools that are subject to much stricter state regulation.<sup>52</sup> Since 1991, forty-two other states and the District of Columbia have passed charter school legislation.<sup>53</sup> As of 2014, there were over 6,500 charter schools throughout America.<sup>54</sup> Between 1999 and 2016, student enrollment in charter schools has increased from 300,000 to 2.9 million.<sup>55</sup> The

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<sup>47</sup> Davis, *supra* note 26, at 6; James Forman, *Do Charter Schools Threaten*, 2007 U. ILL. L. REV. 839, 843 (2007).

<sup>48</sup> Patrick J. Gallo, *Reforming the "Business" of Charter Schools in Pennsylvania*, 2014 BYU EDUC. & L.J. 207, 208–09 (2014).

<sup>49</sup> Dylan P. Grady, *Charter School Revocation: A Method for Efficiency, Accountability, and Success*, 41 J.L. & EDUC. 513, 520–22 (2012).

<sup>50</sup> David Groshoff, *Uncharted Territory: Market Competition's Constitutional Collision with Entrepreneurial Sex-Segregated Charter Schools*, 2010 BYU EDUC. & L.J. 307, 357 n.2 (2010).

<sup>51</sup> Liu, *supra* note 4, at 276.

<sup>52</sup> Davis, *supra* note 26, at 5.

<sup>53</sup> *Laws and Legislation*, THE CENTER FOR EDUCATION REFORM, <https://www.edreform.com/issues/choice-charter-schools/laws-legislation/> (last visited June 3, 2016).

<sup>54</sup> *Charter School Enrollment*, NATIONAL CENTER FOR EDUCATION STATISTICS, [https://nces.ed.gov/programs/coe/indicator\\_cgb.asp](https://nces.ed.gov/programs/coe/indicator_cgb.asp) (last visited June 3, 2016).

<sup>55</sup> *Id.*; NATIONAL ALLIANCE, *supra* note 16.

rapid spread of charter schools in the wake of authorizing legislation is largely attributed to the bipartisan appeal of charter schools.<sup>56</sup>

While states may statutorily permit “local districts, state departments of education, or universities” the ability to grant charters to specific groups outlined in their respective statutes, the chartering process itself varies greatly between states.<sup>57</sup> States often require that charters last for specific lengths of time as opposed to allowing them to continue in perpetuity.<sup>58</sup> Depending on the state, charter schools may be either nonprofit or for-profit. For example, several states including Arizona, Virginia, Colorado, and Wisconsin have enacted statutes that are silent on which form charter schools must choose.<sup>59</sup> However, the majority of charter schools operate as nonprofits, in part because many states require it.<sup>60</sup> This Note will concentrate on nonprofit charter schools, as they constitute the bulk of charter schools.

There are several further characteristics that define charter schools. Charter schools do not charge students tuition.<sup>61</sup> In place of tuition, charter schools receive funding from the district and state based on the average daily attendance of pupils.<sup>62</sup> States do not, however, provide charter schools with funding for facilities.<sup>63</sup> Charter schools must rely on other

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<sup>56</sup> See Kathryn Kraft, *Cyber Charter Schools—An Analysis of Their Legality*, 56 SMU L. REV. 2327, 2330 (2003) (“Republicans support charter schools because these schools provide competition to traditional public schools, operate without the burdens of state or local regulations, and must produce strong results in order to continue operating. Democrats support charter schools because they present a new approach to education while adhering to the core values of traditional public schools. Democrats admire charter schools’ innovative approaches to education and appreciate their open admissions process, free cost, and nonsectarian purpose. Most legislators believe these schools will provide flexibility and innovation for school curricula and increase parental involvement.”).

<sup>57</sup> Morley, *supra* note 5, at 1787.

<sup>58</sup> James E. Ryan, *Charter Schools and Public Education*, 4 STAN. J. CIV. RTS. & CIV. LIBERTIES 393, 395 (2008).

<sup>59</sup> ARIZ. REV. STAT. § 15-183 (2002); VA. CODE ANN. §§ 22.1-212.5–22.1-212.16 (Michie 2000 & Supp. 2002); WIS. STAT. ANN. § 118.40(7)(3) (West 1999 & Supp. 2002); TEX. EDUC. CODE ANN. § 12.101(a) (Vernon Supp. 2003).

<sup>60</sup> See FLA. STAT. § 1002.33(18)(f) (2011); ILL. COMP. STAT. ANN. 5/27A-5(a) (West 2006); PA. CONS. STAT. § 17-1702-A (2006).

<sup>61</sup> *About Charter Schools*, NATIONAL ALLIANCE FOR PUBLIC CHARTER SCHOOLS, <http://www.publiccharters.org/get-the-facts/public-charter-schools/> (last visited June 4, 2016).

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

means of securing a facility, such as grants, loans, philanthropic donations, or renting from EMOs.<sup>64</sup> Most state laws preclude charter schools from choosing their students.<sup>65</sup> Instead, like their traditional public school equivalents, charter schools provide open enrollment to all students.<sup>66</sup> In most states, if the number of applications a charter school receives exceeds the number of seats available, the school must use a lottery system to select students for enrollment.<sup>67</sup>

Charter schools differ from traditional public schools in that states do not dictate whom charter schools can hire or what they teach.<sup>68</sup> Charter schools are also “exempt from significant State or local rules that inhibit the flexible operation and management of public schools.”<sup>69</sup> This autonomy tends to give charter schools free reign over resource and budget allocation, staffing, and curriculum creation and implementation.<sup>70</sup> Many states still require charter schools to observe certain regulations concerning “class size, graduation, bilingual education, special education, health, safety, and civil rights.”<sup>71</sup>

### C. Charter School Benefits and Goals

State governments hoped to revitalize K–12 education with charter school legislation by allowing teachers to employ the “dynamism and experimentation available in autonomous private schools” combined with public state funding available to public schools.<sup>72</sup> Charter schools therefore inhabit a gray

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<sup>64</sup> *Id.*

<sup>65</sup> *Id.*; *Charter School Procedures*, NATIONAL ALLIANCE FOR PUBLIC CHARTER SCHOOLS, <http://www.publiccharters.org/law-database/clear-student-recruitment-enrollment-lottery-procedures/> (last visited June 4, 2016).

<sup>66</sup> *Charter School Procedures*, *supra* note 65. *But see* Valerie Strauss, *How Charter Schools Choose Desirable Students*, WASH. POST (Feb. 16, 2013), <https://www.washingtonpost.com/news/answer-sheet/wp/2013/02/16/how-charter-schools-choose-desirable-students/> (describing situations where many charter schools have been indirectly selecting students by setting barriers to admissions such as requiring students to submit long essays, mandatory family interviews, academic prerequisites, lengthy application forms, and assessment exams).

<sup>67</sup> *Charter School Procedures*, *supra* note 65.

<sup>68</sup> Morley, *supra* note 5, at 1788.

<sup>69</sup> 20 U.S.C.A. § 7221i(1)(E) (West 2003).

<sup>70</sup> Liu, *supra* note 4, at 278.

<sup>71</sup> *Id.* at 279. Under Illinois’ administrative code title 23 relating to special education, charter schools are to be treated as schools within school districts over which the board of education has jurisdiction. As such, charter schools must comply with the “special education” part of the code. *Id.*

<sup>72</sup> Davis, *supra* note 26, at 8.

area between wholly “public” and “private” schools by borrowing aspects of both and incorporating them into a single educational institution, but with the constraint of needing to “produce certain result[s] . . . set forth in each charter school’s charter.”<sup>73</sup>

Beyond the purported educational advantages that states hope to achieve, there are several other charter school advantages. First is an enhanced ability of charter schools to attract resources.<sup>74</sup> Outside of state and federal funding, nonprofit charter schools can receive supplemental resources in the form of volunteer staff and donated funds.<sup>75</sup> Charter schools may then use these resources to advance their purpose and bridge any gaps in funding. Second, charter schools receive “localized governance.” This differs from the typically centralized traditional public school structure that can lead to student alienation and the removal of “authority for crucial decisions like curriculum design from those best positioned to make them.”<sup>76</sup> In contrast to traditional public schools, charter schools tend to be smaller, and this encourages improved school governance and greater parental involvement in a child’s education.<sup>77</sup> Charter authorizers can therefore design rules and academic performance standards tailored to a charter school’s student body.<sup>78</sup> The decentralized nature of charter schools’ management also leads to greater accountability than is present in traditional public schools.<sup>79</sup> Charter school authorizers, and not “of system aggregates” as is the case with traditional public schools, are responsible for the performance of individual charter schools.<sup>80</sup> As such, a charter school will not survive if it performs poorly because it cannot hide among the collective success of other schools in its school system.<sup>81</sup> Third, when schools in popular city districts are overcrowded, especially those districts where “at-risk” children reside, an

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<sup>73</sup> Monica Teixeira de Sousa, *Compelling Honesty: Amending Charter School Enrollment Laws to Aid Society’s Most Vulnerable*, 45 URB. LAW. 105, 135 n.2 (2013).

<sup>74</sup> Morley, *supra* note 5, at 1814.

<sup>75</sup> *Id.* at 1805.

<sup>76</sup> *Id.* at 1815.

<sup>77</sup> *Id.*

<sup>78</sup> Walker Richmond, *Charter School Accountability: Rhetoric, Results, and Ramifications*, 12 VA. J. SOC. POL’Y & L. 330, 340 (2004).

<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at 341.

<sup>81</sup> *Id.*

operator can apply to open a charter school in that area to alleviate the strain on an overloaded public school.<sup>82</sup> Other purported benefits include desegregation and decreased need for spending resources on union contracts.<sup>83</sup>

#### *D. Charter School Performance and Purposes*

Results and opinions vary greatly as to whether nonprofit charter schools have succeeded in providing a better or more “innovative” public education in comparison to traditional public schools.<sup>84</sup> The main issue with evaluating charter school success is that they differ substantially state-to-state.<sup>85</sup> Two meta-analyses of several studies assessing charter school success found that making a broad conclusion about charter school success across America may be “premature.”<sup>86</sup> However, a recent study comparing traditional public schools against charter schools across fifteen states and the District of Columbia concluded that the majority of charter schools evaluated did not do significantly better or worse overall than traditional public schools.<sup>87</sup> Thus, charter schools do not necessarily provide “better” education than traditional public schools through “innovative” teaching methods or giving local community members greater control over education. Instead charter schools supply an education approximately on par with traditional public schools to communities with little or no access to other education options.<sup>88</sup> While some charter schools exist solely to provide parents with educational institution options, charter schools also function essentially as education “gap-closers” aimed at “improving the outcomes of at-risk student populations.”<sup>89</sup>

Having provided a thorough summary of the charter school movement, this Note will now offer an overview of for-profit EMOs that partially or fully operate nonprofit charter schools.

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<sup>82</sup> Liu, *supra* note 4, at 296–97.

<sup>83</sup> Morley, *supra* note 5, at 1814.

<sup>84</sup> Dylan P. Grady, *Charter School Revocation: A Method for Efficiency, Accountability, and Success*, 41 J.L. & EDUC. 513, 527–31 (2012).

<sup>85</sup> *Charter Schools: Finding out the Facts: At a Glance*, CENTER FOR PUBLIC EDUCATION (2010), <http://www.centerforpubliceducation.org/Main-Menu/Organizing-a-school/Charter-schools-Finding-out-the-facts-At-a-glance> (last visited June 4, 2016).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> Liu, *supra* note 4, at 295.

<sup>89</sup> *Id.*

### III. EDUCATION MANAGEMENT ORGANIZATION OVERVIEW

#### A. *What Are For-Profit EMOs?*

EMOs are private for-profit businesses that contract mostly with charter schools to either operate them entirely or provide a wide range of services in exchange for a portion (or all) of the public funding that charter schools receive.<sup>90</sup> Such services can include curriculum creation, hiring teachers, school management, and providing bulk teaching supplies like pencils, books, computers, and the like.<sup>91</sup> EMOs are distinct from “vendors” that provide a narrow range of services such as legal services, accounting, benefits, and payroll.<sup>92</sup> EMOs are also different than Charter Management Organizations (“CMOs”), which carry out similar functions to EMOs, but do not operate for-profit.<sup>93</sup> The largest American EMOs include National Heritage Academies, Edison Learning Inc., and White Hat.<sup>94</sup> While there was an explosive increase in the number of EMOs during the 1990s into the early 2000s, the emergence of new EMOs has slowed.<sup>95</sup> EMOs are now beginning to consolidate, resulting in a greater number of charter schools being run by large EMOs.<sup>96</sup> As of 2016, EMOs ran 995 charter schools in the United States, which is approximately 15% of all charter schools.<sup>97</sup>

Charter schools and EMOs enter into operation contracts that outline the relationship between the parties.<sup>98</sup> Operation contracts vary in describing what services the EMO will provide, but they are generally used as an accountability measure to track the EMO’s fiscal responsibility and progress

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<sup>90</sup> Kary Moss, *The Right to Read*, 15 J.L. SOC’Y 187, 206 (2014) (“Charter schools account for nearly 93.9% for all EMO-managed schools.”).

<sup>91</sup> Lewis D. Solomon, *Edison Schools and the Privatization of K-12 Public Education: A Legal and Policy Analysis*, 30 FORDHAM URB. L.J. 1281, 1284 (2003).

<sup>92</sup> Matthew D. Bernstein, *Whose Choice Are We Talking About? The Exclusion of Students with Disabilities from For-Profit Online Charter Schools*, 16 RICH. J.L. & PUB. INT. 487, 501 (2013).

<sup>93</sup> Sean Sandoloski, *Profiting on America’s Youth? A Study of Educational Management Organizations*, 37 OHIO N.U. L. REV. 199, 204 (2011).

<sup>94</sup> Miron, *supra* note 34, at 478.

<sup>95</sup> *Id.* at 5.

<sup>96</sup> Anne E. Trotter, *Education Management Organizations and Charter Schools: Serving All Students*, 213 EDUC. LAW REP. 935, 940–41 (2006).

<sup>97</sup> NATIONAL ALLIANCE, *supra* note 16.

<sup>98</sup> Trotter, *supra* note 96, 23.



toward improving student body performance.<sup>99</sup> When the contract is close to its expiration date, the charter school can examine whether the EMO met the benchmarks laid out in the contract and decide whether to continue partnering with the EMO. EMOs typically do not hold the charter originally granted to the charter school operators.<sup>100</sup> However, few EMO contracts allow charter school boards to own the charter school's physical property.<sup>101</sup> Instead, many contracts state that the EMO owns the school's physical assets.<sup>102</sup> The EMO will then typically lease the property back to the charter school.<sup>103</sup>

*B. What Are the Benefits and Shortcomings of EMOs in the Nonprofit Charter School Movement?*

There are several arguments in favor of EMOs partnering with charter schools. First, EMOs allow charter schools to take advantage of economies of scale.<sup>104</sup> That is, EMOs are able to bargain with vendors when purchasing lunch service for use throughout all of the charter schools an EMO operates, and EMOs can negotiate for lower prices when buying textbooks or computers in bulk, thus spending less money per pupil.<sup>105</sup> Second, as newer players in the education field, EMOs are better positioned to experiment with and tweak different programs that allow for happier teachers and better educated students than the entrenched procedures present in many traditional public school systems and other sub-standard independent charter schools.<sup>106</sup> Third, EMOs provide enhanced accountability.<sup>107</sup> If parents or charter schools do not like an EMO's progress toward improving student education, parents can withdraw their children and charter schools can end their contract after the contract's term ends.<sup>108</sup> Finally, EMOs provide expert assistance in addressing major problems that

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<sup>99</sup> Gary Miron, *Education Management Organizations* 2 (2007), [http://a100educationalpolicy.pbworks.com/f/EMO\\_History.pdf](http://a100educationalpolicy.pbworks.com/f/EMO_History.pdf).

<sup>100</sup> Bernstein, *supra* note 92, at 501.

<sup>101</sup> Nelson, *supra* note 7, at 276.

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> Sandoloski, *supra* note 93, at 203.

<sup>105</sup> *Id.*

<sup>106</sup> *Id.* at 206; Trotter, *supra* note 96, at 936.

<sup>107</sup> Trotter, *supra* note 96, at 936.

<sup>108</sup> *Id.*

new charter schools face such as “overwhelm[ing] . . . paperwork, securing facilities, financial management, and overall lack of resources.”<sup>109</sup>

There are also several shortcomings to EMOs contracting with nonprofit charter schools. One of the main issues with for-profit EMOs is their inclination toward maximizing shareholder wealth, a common primary goal in the for-profit sector.<sup>110</sup> This principle is problematic specifically for EMOs in the education sector, because delivering increased shareholder and investor profits may force EMOs to choose a lower-cost means of educating students in charter schools that negatively impacts the quality of education the students receive, or EMOs may engage in questionable business practices to deliver returns.<sup>111</sup> An analogy can be drawn between EMO-charter school partnerships and the pitfalls of the for-profit college (“FPC”) business model, which has been under media and government fire for the past decade following allegations of “financial aid fraud, gross misrepresentations to students, and deceptive business practices.”<sup>112</sup> FPCs accrue money in a similar way to EMOs, except FPC money comes from federal student loans and GI Bill grants instead of from public funds redirected from traditional public schools, with federal financial aid providing over \$20 billion to FPCs every year.<sup>113</sup> Like EMOs, FPCs differ from their state-run counterparts in that the former are largely directed by publically traded companies or private equity firms, and the latter are largely directed by trustees primarily motivated by educational outcome.<sup>114</sup> One well-known FPC, the University of Phoenix, spent \$400,000 a day on advertising in 2012.<sup>115</sup> The reason

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<sup>109</sup> Miron, *supra* note 99.

<sup>110</sup> Conn, *supra* note 9, at 254.

<sup>111</sup> *Id.*

<sup>112</sup> Aarmer Madhani, *New Federal Rules Target For-Profit Colleges*, USA TODAY (Mar. 17, 2014, 1:48 PM), <http://www.usatoday.com/story/news/politics/2014/03/13/obama-for-profit-college-regulations/6386565/>; Rebecca E. Reif, *Knowledge Is Power: Reform of For-Profit Educational Institutions on an Individual and Institutional Level*, 61 DRAKE L. REV. 251, 253 (2012).

<sup>113</sup> Sarah Anne Schade, *Reining in the Predatory Nature of For-Profit Colleges*, 56 ARIZ. L. REV. 317, 328 (2014).

<sup>114</sup> *Id.* at 322; Maura Dundon, *Students or Consumers? For-Profit Colleges and the Practical and Theoretical Role of Consumer Protection*, 9 HARV. L. & POL'Y REV. 375, 376 (2015).

<sup>115</sup> Schade, *supra* note 113, at 323.

FPCs spend such large amounts of money on advertising is to target one demographic: “vulnerable populations, including the underemployed and out-of-work, military personnel and their families, low-income students with no prior college experience, community college students, and minorities.”<sup>116</sup> By targeting these vulnerable populations, FPCs can increase enrollment and multiply the amount of money FPCs receive in the form of federal student loans, which they then use to expand their operations and maximize shareholder and investor profits.<sup>117</sup> FPCs tout many of the same advantages that EMOs advertise, such as flexibility in meeting student needs.<sup>118</sup> The FPC’s main selling point is that they claim to teach students “skilled trades” or “vocational skills,” making students job-ready upon graduation.<sup>119</sup>

In recent years, FPCs have been plagued with poor results and engaging in fraudulent activities, such as deceptive marketing practices.<sup>120</sup> Much like EMO and charter school partnerships, some commentators argue that in theory, FPCs can be beneficial in the education field because they can help “nontraditional students successfully complete college programs with workplace skills that enable them to get good jobs in a tough economy.”<sup>121</sup> However, like with EMOs, reform is necessary to prevent further exploitation of students and federal government financial aid.<sup>122</sup> In the case of FPCs, commentators argue that the government should be more selective when allocating student loans to students attending FPCs, because although for-profit students make up only 11% of the higher education population, they account for 44% of all federal student loan defaults.<sup>123</sup> The result of government intervention for FPCs was the reduction of their main stream of income—namely, federal student loans. In order to avoid a similar result, EMOs could learn from the situation currently facing FPCs and rebrand themselves as benefit corporations to

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<sup>116</sup> Amanda Harmon Cooley, *The Need for Legal Reform of the For-Profit Educational Industry*, 79 TENN. L. REV. 515, 528–29 (2012).

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* at 525.

<sup>119</sup> *See* Reif, *supra* note 112, at 275.

<sup>120</sup> Dundon, *supra* note 114, at 377.

<sup>121</sup> Reif, *supra* note 112, at 275.

<sup>122</sup> *Id.*

<sup>123</sup> Note, *Forgive and Forget: Bankruptcy Reform in the Context of For-Profit Colleges*, 128 HARV. L. REV. 2018, 2019 (2015).

mitigate the increased government and media scrutiny.

Although in theory charter school administrators may end contracts with EMOs if the EMO does not perform well in carrying out the contract's terms, there are problems and costs associated with ending a contract that may dissuade a charter school from terminating the agreement.<sup>124</sup> These include the availability of adequate replacement EMOs, the cost involved in searching for and switching to a different EMO, whether the charter school has available funds to contract with another EMO, the loss of property to the EMO that the charter school administrators leased to house their student body, and intertwinement of charter school board members with the managing EMO.<sup>125</sup> Another drawback occurs in situations where an EMO fully operates a charter school. In such cases, EMOs may have a tendency to assert their authority over charter schools in such a way that they interrupt the charter school's founding principles.<sup>126</sup>

Aside from the shareholder wealth-maximization axiom and the difficulty exiting from contracts with EMOs, there is one overarching problem that has brought EMOs into the national spotlight: misusing public funding that charter schools pay for-profit EMOs in exchange for operating the charter school. Misusing public funding has resulted in states banning EMOs from contracting with charter schools.<sup>127</sup> This Note will now examine two specific instances where for-profit EMOs have either misused taxpayer money or are not transparent about how they spend taxpayer money. These instances highlight the need for EMOs to become benefit corporations as a means of increasing accountability and showing state legislatures that EMOs are serious about both making profits and advancing charter school education. The first scenario concerns auditors who are not able to track how EMOs have spent the taxpayer money that charter schools pay EMOs. The second situation is where EMOs have inflated charter school rent, sometimes redirecting over one-third of a charter school's funding to pay

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<sup>124</sup> Katrina E. Bulkley, *Losing Voice? Educational Management Organizations and Charter Schools' Educational Programs*, 37 EDUC. & URB. SOC'Y. 204, 228–230 (2005).

<sup>125</sup> *Id.*

<sup>126</sup> Trotter, *supra* note 96, at 941–42.

<sup>127</sup> See NEW YORK CITY CHARTER SCHOOL CENTER, *supra* note 19 and accompanying text.

rent for the charter school's facilities.

*C. Examples of EMOs Misusing Taxpayer Money*

*1. A lack of transparency when tracking how EMOs spend charter school money*

The majority of EMOs are private companies, and, as such, once public funds pass from the charter school to the EMO, regulators, auditors, and charter schools are unable to track how the EMO spends the money.<sup>128</sup> This is because, as private companies, EMOs are not subject to many of the public disclosures and transparency rules that other public entities, such as traditional public schools, must observe.<sup>129</sup> A lack of transparency is especially troublesome for charter schools that enter into contracts where a charter school hands over a substantial amount of its funding, usually between 95 and 100%, to the EMO.<sup>130</sup> In 2010, New York state auditors tried to track \$10 million in taxpayer public funding that passed through Brooklyn Excelsior Charter School in New York City into National Heritage Academies, a large for-profit EMO that the charter school had contracted with for full operation and management services.<sup>131</sup> The auditors concluded that they were “unable to verify the true cost of Excelsior’s operations or determine the extent to which the \$10 million of annual public funding provided to the school was actually used to benefit its students” because National Heritage, claiming they were “proprietary, refused to provide financial reports.”<sup>132</sup> Excelsior’s lack of transparency as to how the EMO they contracted with spent public funding is an all-too-common phenomenon in the EMO-charter school partnership world, and is partly responsible for the legislative and media backlash against such partnerships.<sup>133</sup> By rebranding as benefit corporations, EMO

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<sup>128</sup> Wang, *supra* note 32, at 2.

<sup>129</sup> Parker Baxter et al., *Public Accountability & Transparency of Charter Schools & Management Organizations* (2015), <http://www.publiccharters.org/wp-content/uploads/2015/09/APCSA-Public-Accountability-One-Page.pdf>.

<sup>130</sup> Wang, *supra* note 32, at 2.

<sup>131</sup> Thomas P. DiNapoli, New York State Office of the State Comptroller Division of State Government Accountability, *Oversight of Financial Operations: Brooklyn Excelsior Charter School* 5 (Dec. 2012), <http://www.osc.state.ny.us/audits/allaudits/093013/11s14.pdf>.

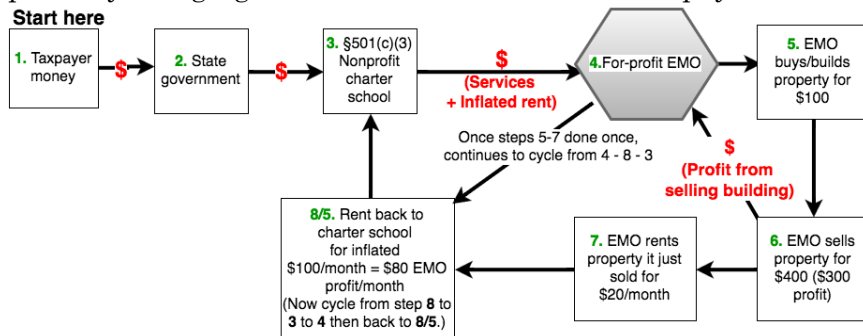
<sup>132</sup> *Id.*

<sup>133</sup> DeJarnatt, *supra* note 2, at 58–66.

transparency would be mandatory. EMOs could use their rebranding efforts to separate themselves from those EMOs that refuse to share their financial records with auditors. This could lessen the chance that state legislatures ban EMO-charter school partnerships.

## 2. EMOs are charging charter schools inflated rent and creating conflicts of interest

Real estate transactions involving inflated rent and conflicts of interest constitute the bulk of dishonest business dealings that have facilitated government scrutiny when it comes to EMO-charter school contracts. Real estate makes up a substantial portion of the profits that EMOs receive when partnering with charter schools.<sup>134</sup> Charter schools that partner with EMOs usually do not own their facilities.<sup>135</sup> Instead, charter schools that partner with EMOs rent school facilities from the EMO.<sup>136</sup> Most EMO-charter school property transactions follow a similar set of steps as depicted below. First, the EMO will purchase or build a facility for the charter school.<sup>137</sup> The EMO will improve the facility and then sell it at a profit.<sup>138</sup> The EMO then leases the property back from the buyer, and subleases the property to a charter school, making a profit by charging far more than the EMO's lease payments.<sup>139</sup>



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<sup>134</sup> *Id.* at 47.

<sup>135</sup> Bernstein, *supra* note 92, at 501.

<sup>136</sup> Candisky, *supra* note 15.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

<sup>140</sup> Flowchart created by the author using [www.draw.io](http://www.draw.io). The dollar amounts are used for ease to track how EMOs are able to profit from real estate transactions with charter schools. These transactions will typically run into the hundreds of thousands to

In some cases, the EMO will simply hold onto the property and charge the charter schools far in excess of the EMO's mortgage payments.<sup>141</sup> In many cases, the EMO will calculate rents to obtain maximum reimbursement from state public funding instead of reflecting the property's fair market value.<sup>142</sup>

There are two troubling scenarios where EMO-charter school facility rental agreements are concerned. In the first, EMOs sometimes charge charter schools inflated rent.<sup>143</sup> Typically, charter schools should not allocate more than 20% of their operating budget to renting their facilities.<sup>144</sup> However, in some cases charter schools give over one-third of their operating costs to EMO landlords.<sup>145</sup> By spending excessive amounts on rent, charter schools spend less money on student instruction. The second troubling scenario occurs where there are conflicts of interest between EMO operators and charter school operators concerning rental agreements.<sup>146</sup> In 2014, the U.S. Department of Education investigated Florida's largest EMO, Academica Corp., for potential conflicts of interest in its business dealings with Mater Academy charter schools.<sup>147</sup> The audit found that Academica had created the original nonprofit Mater Academy in 1998. Since then, several schools in the Mater network entered into lease agreements with development companies tied to Academica, thereby filtering public funding through nonprofit charter schools into the for-profit EMO.<sup>148</sup> Audits in other states, including Pennsylvania, have found similar conflicts of interest involved in real estate agreements.<sup>149</sup> Real estate transactions involving inflated rent

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millions of dollars in actual transactions.

<sup>141</sup> Jennifer Dixon, *Michigan's Biggest Charter Operator Charges Big Rents: 14 Schools Pay \$1M*, DETROIT FREE PRESS (June 22, 2014, 1:50 AM), <http://www.freep.com/story/news/local/michigan/2014/06/22/michigans-biggest-charter-operator-charges-big-rents-14-schools-pay/77155250/>.

<sup>142</sup> DeJarnatt, *supra* note 2, at 73.

<sup>143</sup> Rawls, *supra* note 12.

<sup>144</sup> *Id.*

<sup>145</sup> Dixon, *supra* note 141; DeJarnatt, *supra* note 2, at 73.

<sup>146</sup> Davis, *supra* note 26, at 13. For example, the former chairwoman for a charter school negotiated with an EMO that she had multiple family ties with, including a lease agreement which obligated the charter school to pay \$98,000 a month for a school building. *Id.*

<sup>147</sup> McGrory, *supra* note 6.

<sup>148</sup> *Id.*

<sup>149</sup> FRAUD & STORY INVESTIGATIONS OFFICE OF THE CONTROLLER, REVIEW OF CHARTER SCHOOL OVERSIGHT: A FRAUD VULNERABILITY ASSESSMENT J-4 (Apr. 2010), <http://www.philadelphiacontroller.org/publications/other%20reports/CharterSchoolInve>

and conflicts of interest constitute the bulk of dishonest business dealings that have facilitated government scrutiny when it comes to EMO-charter school contracts, and have highlighted a greater need for EMO transparency in order to prevent states banning their partnerships with charter schools.

#### IV. BENEFIT CORPORATIONS: THE PATH TO RESTORING TRUST IN EDUCATION MANAGEMENT ORGANIZATIONS AND NONPROFIT CHARTER SCHOOL AFFILIATIONS

In light of this need for greater accountability and transparency among EMOs in order to prevent states from banning their association with charter schools, the benefit corporation offers EMOs the opportunity to rebrand and show that they can do good while generating profits.<sup>150</sup> In a post-Enron world where there is a growing dissatisfaction with the corporate landscape, benefit corporation legislation offers several benefits of which current and future EMOs can take advantage.<sup>151</sup> First, benefit corporations have amplified accountability. Thus, by branding themselves as benefit corporations, EMOs can increase transparency that the benefit corporation structure requires.<sup>152</sup> Second, benefit-corporation branding allows EMOs to make up for the investors they may lose. A double- or triple-bottom line approach that capitalizes on “socially responsible investment trends” may compensate for lost investors.<sup>153</sup>

##### A. *Why Was the Benefit Corporation Created and What Are Benefit Corporations?*

###### 1. *Why was the benefit corporation created?*

The benefit corporation was created as a means of offering social enterprises the legal protection and certainty that they required to pursue a “dual mission”: advancing a social goal while generating financial returns for investors and

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<sup>150</sup> Resor, *supra* note 36, at 91.

<sup>151</sup> *Id.*

<sup>152</sup> See *infra* note 203 and accompanying text.

<sup>153</sup> Sarah Thornsberry, *More Burden Than Benefit? Analysis of the Benefit Corporation Movement in California*, 7 J. BUS. ENTREPRENEURSHIP & L. 159, 184 (2013).



shareholders.<sup>154</sup> Instead of pursuing a single bottom line, social enterprises sought to pursue a triple bottom line, “pursuing not only economic prosperity, but also environmental quality and social good.”<sup>155</sup> Before states passed benefit corporation legislation, groups seeking to pursue a public mission generally had two choices of business entity.

The first choice offers social enterprises the opportunity to become traditional for-profit corporations. The corporate form affords businesses certain benefits, such as limited director liability, transferability of stock, and the ability to raise capital easily.<sup>156</sup> However, for-profit corporations generally follow the shareholder maximization norm that pervades the for-profit sector, while eschewing decisions that consider other interests at the expense of shareholder profits.<sup>157</sup> While the holdings in two famous corporate law cases, *Dodge v. Ford Motor Co.*<sup>158</sup> and *eBay Domestic Holdings, Inc. v. Newmark*,<sup>159</sup> are commonly understood as *requiring* directors to consider only shareholder profits while prohibiting directors and managers from contemplating other socially beneficial objectives, this interpretation misconstrues the current state of corporate law and the reason behind the shareholder maximization axiom.<sup>160</sup> The heart of the Model Benefit Corporation Legislation (“Model

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<sup>154</sup> J. William Callison, *Putting New Sheets on a Procrustean Bed: How Benefit Corporations Address Fiduciary Duties, the Dangers Created, and Suggestions for Change*, 2 AM. U. BUS. L. REV. 85, 88–89 (2012). See Robert Katz, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 86 (2010) (defining “social enterprise” as an entity having profit-making goals while also embracing the duty to sometimes make decisions that will not maximize profit and sharing some of the social aims of a nonprofit corporation).

<sup>155</sup> Thornsberry, *supra* note 153, at 163.

<sup>156</sup> See Stephen G. Christianson, *Liability of a Director to a Corporation for Mismanagement*, 29 AM. JUR. PROOF OF FACTS 3d 133, § 10; DEL. CODE ANN. tit. 8, § 102(b)(7); DEL. CODE ANN. tit. 8, § 151.

<sup>157</sup> Resor, *supra* note 36, at 95.

<sup>158</sup> 170 N.W. 668 (Mich. 1919).

<sup>159</sup> 16 A.3d 1 (Del. Ch. 2010).

<sup>160</sup> Kevin V. Tu, *Socially Conscious Corporations and Shareholder Profit*, 84 GEO. WASH. L. REV. 121, 154–55 (2016); see *eBay Domestic Holdings*, 16 A.3d 1 (“When director decisions are reviewed under the business judgment rule, this Court will not question rational judgments about how promoting non-stockholder interests—be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture—ultimately promote stockholder value.” What is unclear from this ruling is whether the business judgment rule will protect directors when they promote non-shareholder interests without tying that decision into how promoting non-shareholder values will promote shareholder value. This is the gray area the benefit corporation seeks to resolve by specifically allowing benefit corporations to pursue both a social mission and profit generation.); see also *Dodge*, 170 N.W. 668.

Legislation”) is premised on the misconception that *Dodge* and *eBay Domestic Holdings* hold that directors *must* maximize the corporation’s financial value.<sup>161</sup> However, these two cases actually *allow* directors to consider broader stakeholder interests if directors can justify such considerations with any “rational business purpose.”<sup>162</sup> Although the business judgment rule generally protects directors of for-profit corporations from shareholder and judicial questioning of business decisions that are “rationally connected to shareholder benefit,” any decision that lacks this causation could leave directors open to lawsuits.<sup>163</sup> As such, the justification for benefit corporations does not stem from a legally enforced shareholder maximization norm that prevents groups from considering the interests of other stakeholders, such as employees, at the expense of shareholder pecuniary interests, because such a prohibition does not exist in corporate law.<sup>164</sup> Instead, benefit corporations are justified because of uncertainty surrounding the “interplay between the duty of loyalty and managerial discretion.”<sup>165</sup>

This uncertainty plays out in not knowing how much latitude managers and directors have in making decisions that benefit stakeholders other than shareholders.<sup>166</sup> As such, the benefit corporation creates a new corporate form that eliminates legal uncertainties present in for-profit corporations, and not only allows but mandates that managers and directors balance various stakeholder interests when making business decisions.<sup>167</sup> One corporate form in particular, the limited liability company (“LLC”), has been a popular choice for social enterprises in lieu of the benefit corporation because it offers structural and organizational flexibility, such as the single taxation available to partnerships combined with

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<sup>161</sup> MODEL BENEFIT CORP. LEG. § 301 (Apr. 2016).

<sup>162</sup> Tu, *supra* note 160, at 155.

<sup>163</sup> J. William Callison, *Benefit Corporations, Innovation, and Statutory Design*, 26 REGENT U. L. REV. 143, 144–45 (2014); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (The business judgment rule “is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”).

<sup>164</sup> Kyle Westaway, *The Benefit Corporation: An Economic Analysis with Recommendations to Courts, Boards, and Legislatures*, 62 EMORY L.J. 999, 1012 (2013).

<sup>165</sup> Tu, *supra* note 160, at 155.

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

the limited liability that a corporation's directors enjoy.<sup>168</sup> But LLCs lack an accountability structure that allows shareholders to check that the LLC is advancing the social enterprise's social mission.<sup>169</sup>

A social enterprise could also become a nonprofit corporation. Nonprofit corporations exist to provide "public goods" in situations where contract failure has occurred.<sup>170</sup> The nonprofit entity is aligned with a social enterprise's goal of advancing a social good.<sup>171</sup> But a social enterprise would not be able to generate profits for shareholders because nonprofits are prohibited from distributing profits, nor can they have shareholders.<sup>172</sup> Instead, any earnings that are not paid for "services rendered to the organization . . . must be retained and devoted in their entirety to financing further production of the services that the organization was formed to provide."<sup>173</sup> With the advent of the benefit corporation, social enterprises now have a third option: a new type of legal entity that combines the nonprofit corporation's goal of "making the world . . . a better place" with the traditional for-profit corporation's goal of producing profits for shareholders and investors.<sup>174</sup>

## 2. *What is the benefit corporation?*

In 2010, B Lab, a nonprofit corporation whose mission is "to use the power of business to solve social and environmental problems," promulgated the Model Legislation that allows the formation of benefit corporations as legal corporate entities.<sup>175</sup>

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<sup>168</sup> Anna R. Kimbrell, *Benefit Corporation Legislation: An Opportunity for Kansas to Welcome Social Enterprises*, 62 U. KAN. L. 549, 554 (2013); Thornsberry, *supra* note 153, at 171.

<sup>169</sup> Thornsberry, *supra* note 153, at 171.

<sup>170</sup> JAMES J. FISHMAN ET AL., *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 28–30 (5th ed. 2015) ("Contract failure" occurs in situations where "ordinary contractual devices in themselves do not provide consumers with adequate means for policing the performance of producers. In such situations, the nonprofit form offers consumers the protection of another, broader 'contract'—namely, the organization's commitment, through its nonprofit charter, to devote all of its income to the services it was formed to provide.")

<sup>171</sup> Callison, *supra* note 163, at 145.

<sup>172</sup> FISHMAN, *supra* note 170, at 4.

<sup>173</sup> *Id.*

<sup>174</sup> Mark J. Loewenstein, *Benefit Corporations: A Challenge in Corporate Governance*, 68 BUS. LAW. 1007, 1010 (2013).

<sup>175</sup> *About B Lab*, B CORPORATION, <https://www.bcorporation.net/what-are-b-corps/about-b-lab> (last visited June 5, 2016) (The B Lab Certification merely indicates that the corporation meets B Lab's standards).

Since 2010, thirty-one states have passed benefit corporation legislation largely based on the Model Legislation.<sup>176</sup> As of May 2016, approximately 3,188 businesses have incorporated as benefit corporations throughout the thirty-one states that have benefit corporation statutes.<sup>177</sup> Benefit corporations should not be confused with B Corps, which are not legal entities.<sup>178</sup> B Corp status is awarded to corporations that have passed B Lab's "B Lab Certification" process, which measures the corporation's social and environmental performance, transparency, and legal accountability against B Lab's third-party standards.<sup>179</sup>

Benefit corporations are for-profit corporations "with a stated public benefit" requiring the corporation's managers and directors to balance (i) maximizing shareholder profits, (ii) the best interests of stakeholders materially affected by the corporation's conduct, and (iii) the corporation's stated public benefit.<sup>180</sup> The general public benefit that a benefit corporation must consider is defined in the Model Legislation as "[a] material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation."<sup>181</sup> Although benefit corporation statutes differ between the states, they all share three major obligations:

A benefit corporation: (1) has the corporate purpose to create a material, positive impact on society and the environment; (2) expands fiduciary duty to require consideration of nonfinancial interests; and (3) reports on its overall social and environmental performance as assessed against a

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<sup>176</sup> *State by State Status of Legislation*, BENEFIT CORPORATION, <http://benefitcorp.net/policymakers/state-by-state-status> (last visited June 5, 2016).

<sup>177</sup> *Find a Benefit Corp.*, BENEFIT CORPORATION, [http://benefitcorp.net/businesses/find-a-benefit-corp?field\\_bcorp\\_certified\\_value=&state=&title=&submit2=Go&sort\\_by=title&sort\\_order=ASC&op=Go](http://benefitcorp.net/businesses/find-a-benefit-corp?field_bcorp_certified_value=&state=&title=&submit2=Go&sort_by=title&sort_order=ASC&op=Go) (last visited June 5, 2016).

<sup>178</sup> Matthew J. Dulac, *Sustaining the Sustainable Corporation: Benefit Corporations and the Viability of Going Public*, 104 GEO. L.J. 171, 174 (2015).

<sup>179</sup> *Why B Corps Matter*, B CORPORATION, <https://www.bcorporation.net/what-are-b-corps/why-b-corps-matter> (last visited June 5, 2016).

<sup>180</sup> Dulac, *supra* note 178, at 175; see DEL. CODE ANN. tit. 8, §362(a).

<sup>181</sup> MODEL BENEFIT CORP. LEG. § 102. *But see* DEL. CODE ANN. tit. 8, § 362 (2014) (Delaware's "Public Benefit Corporation" differs significantly from the Model Legislation promulgated by B Labs in that Delaware requires corporations to identify in its certificate of incorporation a specific public benefit that it will promote. But Delaware does not require its public benefit corporations to use a third-party standard when creating reports.).

comprehensive, credible, independent, and transparent third-party standard.<sup>182</sup>

Benefit corporations therefore differ from traditional for-profit corporations in that benefit corporations are required to consider the impact that their decisions have on society and other stakeholders as well as shareholders.<sup>183</sup> Thus, when people invest in benefit corporations, they can obtain stock price gains and dividends, but shareholders acknowledge that producing a public good may reduce profitability.<sup>184</sup>

Instead of benefit corporation legislation creating a new body of law, the statutes work in tandem with a state's corporate law to allow corporations to form as benefit corporations.<sup>185</sup> As such, a state's corporate statutes continue to apply except where the benefit corporation statute specifically displaces general incorporation statutes.<sup>186</sup> Some states have tweaked B Lab's Model Legislation when passing their own benefit corporation legislation, but the majority of states closely follow B Lab's Model Legislation.<sup>187</sup> Two states in particular, Delaware and Colorado, have adopted statutes with significant changes to the Model Legislation that set them apart from the majority of states that have adopted statutes closely aligned with the Model Legislation.<sup>188</sup> Despite the changes, Delaware and Colorado seek to institute the same principles underlying the Model Legislation.<sup>189</sup> Because many businesses select Delaware as their state of incorporation, this Subpart will first compare the key differences between the Model Legislation and

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<sup>182</sup> Jacob E. Hasler, *Contracting for Good: How Benefit Corporations Empower Investors and Redefine Shareholder Value*, 100 VA. L. REV. 1279, 1286 (2014).

<sup>183</sup> Joseph Karl Grant, *When Making Money and Making a Sustainable and Societal Difference Collide: Will Benefit Corporations Succeed or Fail?*, 46 IND. L. REV. 581 (2013).

<sup>184</sup> Callison, *supra* note 163, at 145.

<sup>185</sup> Hasler, *supra* note 182, at 1286.

<sup>186</sup> Lyman Johnson, *Pluralism in Corporate Form: Corporate Law and Benefit Corps*, 25 REGENT U. L. REV. 269, 279 (2013).

<sup>187</sup> See Loewenstein, *supra* note 174, at 1013 (For example, New Jersey's benefit corporation statute has a provision that says "If a benefit corporation has not delivered a benefit report to the department for a period of two years, the department may prepare and file a statement that the corporation has forfeited its status as a benefit corporation." This provision does not exist in the Model Legislation.); N.J. STAT. ANN. § 14A:18-11 (West).

<sup>188</sup> Kevin Ercoline, *Beyond Puffery, Providing Shareholder Assurance of Societal Good Will in Crowdfunded Benefit Corporations*, 64 AM. U. L. REV. 169, 189 n.70 (2014).

<sup>189</sup> *Id.*

Delaware's benefit corporation legislation and suggest which approach EMOs should choose.<sup>190</sup> And then this Subpart will explore why EMOs should become benefit corporations.

*B. Comparing the Model Benefit Corporation Legislation with Delaware's "Public Benefit Corporation" Statute as a Means of Deciding Which Statute Would Benefit EMOs the Most*

B Labs are the foremost advocates of benefit corporations and they created the Model Legislation to assist states in creating their own benefit corporation statutes. Delaware has enacted its own version of the Model Legislation.<sup>191</sup> The two approaches differ in relation to the flexibility they allow corporations, with the Delaware approach being more flexible than the Model Legislation. This Subpart will now provide overviews of the main provisions in each statute, suggest which approach EMOs should adopt, and why EMOs should consider becoming benefit corporations.

*1. Overview: Elements of the Model Benefit Corporation approach*

A newly formed benefit corporation's articles of incorporation must state that it is a benefit corporation.<sup>192</sup> An existing corporation may become a benefit corporation by amending its articles of incorporation to state that it is a benefit corporation, and to be effective, the amendment must be adopted by a "minimum status vote."<sup>193</sup> A benefit corporation must create a "general public benefit" in addition to the corporation's purpose under the state's corporate law.<sup>194</sup> A "general public benefit" is defined as a "material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and

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<sup>190</sup> Alicia E. Plerhoples, *Delaware Public Benefit Corporations 90 Days Out: Who's Opting In?*, 14. U.C. DAVIS BUS. L.J. 247, 248 (2014).

<sup>191</sup> DEL. CODE ANN. tit. 8, § 362.

<sup>192</sup> MODEL BENEFIT CORP. LEGIS. § 103 (2016).

<sup>193</sup> *Id.* at § 104; *see id.* § 102 (defining "minimum status vote" as requiring the "affirmative vote of the shareholders of each class or series entitled to cast at least two-thirds of the votes that all shareholders of the class or series are entitled to cast on the action").

<sup>194</sup> *Id.* at § 201(a).

operations of a benefit corporation.”<sup>195</sup> The Model Legislation does not state who is to apply the third-party standard. A benefit corporation may also state a “specific public interest,” but this is not a requirement under the Model Legislation.<sup>196</sup>

The benefit corporation’s board of directors must “consider the effects of any action or inaction upon”: (i) shareholders, (ii) employees, (iii) customers “as beneficiaries of the general public benefit or a specific public benefit purpose of the benefit corporation,” and (iv) societal factors and community, including communities where the benefit corporation’s offices, facilities, subsidiaries or its suppliers are located.<sup>197</sup> The Model Legislation does not prioritize any particular interest for directors to consider and there is no guidance on this matter. Further, directors are not liable for monetary damages if the benefit corporation fails to pursue or create a general or specific public benefit, which means that only equitable remedies are available to plaintiffs.<sup>198</sup> The business judgment rule protects a director’s business decision with respect to considering the interests of the various benefit corporation stakeholders if the director is (i) not interested in the decision’s subject, (ii) is informed about the subject of the business judgment, and (iii) “rationally believes” the business judgment is in the benefit corporation’s best interests.<sup>199</sup>

A “benefit enforcement proceeding” is any claim for a benefit corporation’s failure to pursue or create general public benefit or specific public benefit purpose in its articles of incorporation, or for violation of statutory obligation, duty, or standard.<sup>200</sup> Benefit enforcement proceedings may only be commenced or maintained directly by the benefit corporation or derivatively.<sup>201</sup> Further, the only parties who may bring a benefit enforcement proceeding are (i) a person or group that

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<sup>195</sup> *Id.* at § 102(a) (“Third party standard” is a “recognized standard for defining, reporting, and assessing corporate social and environmental performance” that is “comprehensive,” developed by an entity not controlled by the benefit corporation, “credible,” and “transparent.”).

<sup>196</sup> *Id.* at § 201(b); *id.* at § 102 (Examples include “providing low-income or underserved individuals or communities with beneficial products or services . . . promoting the arts, sciences, or advancement of knowledge . . . [and] conferring any other particular benefit on society or the environment.”).

<sup>197</sup> *Id.* at § 301(a).

<sup>198</sup> *Id.* at § 301(c).

<sup>199</sup> *Id.* at § 301(e).

<sup>200</sup> *Id.* at § 102(2).

<sup>201</sup> *Id.*

owns at least two percent of the total shares outstanding at the time of the omission or act complained of; (ii) a director; (iii) a person or group owning five percent of equity interests in the corporation's parent corporation; or (iv) other persons identified in the articles of incorporation or benefit corporation's bylaws.<sup>202</sup> This means that although directors must balance the interests of stakeholders other than shareholders, those stakeholders do not have standing to sue a benefit corporation derivatively for failing to create or pursue public benefits.

Benefit corporations must prepare annual benefit reports that satisfy many requirements, including a narrative description of ways the corporation fulfilled its general public benefit, the extent to which the corporation created the public benefit, and any circumstances that obstructed the creation of the general public benefit.<sup>203</sup> The narrative must also include an evaluation of the benefit corporation's overall environmental and social performance against a third-party standard and the compensation paid to each of the corporation's directors.<sup>204</sup> The benefit corporation must send the annual report to each shareholder and post the report on the public portion of the corporation's website.<sup>205</sup>

## 2. *The main differences between the Model Legislation and Delaware approaches*

There are two main differences between the Model Legislation and Delaware's statute. Delaware refers to benefit corporations as "public benefit corporations" ("PBCs"). Further, Delaware's PBC statute is far less restrictive than the Model Legislation.<sup>206</sup> Instead of mandating that PBCs comply with certain provisions, the Delaware statute clarifies the fiduciary duties of the board of directors by expanding their ability to balance various interests. The Delaware statute then expressly allows PBCs to adopt many of the provisions in the statute, but leaves implementation up to the PBC.<sup>207</sup> Delving deeper into

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<sup>202</sup> *Id.* at § 301(c).

<sup>203</sup> *Id.* at § 401(a).

<sup>204</sup> MODEL BENEFIT CORP. LEGIS. § 401(a) (2016).

<sup>205</sup> *Id.* at § 401(a)-(c).

<sup>206</sup> DEL. CODE ANN. tit. 8, § 362(a)(1) (2015). *See* Plerhoples, *supra* note 190, at 254.

<sup>207</sup> J. Haskell Murray, *Social Enterprise Innovation: Delaware's Public Benefit Corporation Law*, 4 HARV. BUS. L. REV. 345, 352 (2014).



Delaware's statute reveals several other significant features that distinguish it from the Model Legislation.

First, Delaware PBCs are required to state a specific public benefit in their charter, and not a general public benefit.<sup>208</sup> Requiring PBCs to identify a specific public benefit was intended to "provide focus to the directors . . . and [to give] investors notice of, and some control over, specific public purposes the corporation serves."<sup>209</sup>

Second, where the Model Legislation requires directors to "consider" the interests of shareholders and beneficiaries of the benefit corporation's public interest, PBCs are required to "*balance* the [1] pecuniary interests of the stockholders, [2] the best interests of those materially affected by the corporation's conduct, and [3] the specific public benefit or public benefits identified in its certificate of incorporation."<sup>210</sup> "Balance" is arguably a stronger term and a more burdensome hurdle for directors to overcome than the Model Legislation's use of "consider."<sup>211</sup> However, there is vast disagreement over the intended meaning of "consider" and "balance" by their respective authors and what effect the difference between these two terms will have.<sup>212</sup>

Third, PBCs are not required to assess their public benefit using a third-party standard.<sup>213</sup> Fourth, Delaware requires PBCs to create a "statement as to the corporation's promotion of the public benefit" once every two years instead of annually.<sup>214</sup> Further, PBCs only need to provide the report to shareholders. They are not required to post it on the public portion of their websites.<sup>215</sup> The shareholder statement must contain (i) the objectives the directors established to promote a public benefit, (ii) the standards the directors created to

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<sup>208</sup> DEL. CODE ANN. tit. 8, § 362(a)(2) (2015).

<sup>209</sup> Murray, *supra* note 207, at 370 n.153.

<sup>210</sup> DEL. CODE ANN. tit. 8, § 365(a) (2013).

<sup>211</sup> *Id.*

<sup>212</sup> Murray, *supra* note 207, at 355.

<sup>213</sup> Michael A. Hacker, "Profit, People, Planet" *Perverted: Holding Benefit Corporations Accountable to Intended Beneficiaries*, 57 B.C. L. REV. 1747, 1780 (2016) ("Some argue that inclusion of a third-party standard setter negates the possibility of the creation of nominal benefit corporations designed to 'cash in on the cachet of being perceived as 'green' when the corporations are not actually creating any public benefits.").

<sup>214</sup> DEL. CODE ANN. tit. 8, § 366(b) (2013) (But the statute allows for PBCs to require themselves to provide statements more frequently).

<sup>215</sup> *Id.*

measure the corporation's progress in promoting a public benefit, (iii) whether the PBC was objectively successful in promoting a public benefit, and (iv) an assessment of the PBC's success in promoting a public benefit.<sup>216</sup>

Fifth, Delaware's statute does not provide any type of "benefit enforcement proceeding" to compel PBCs to pursue their specific public benefit.<sup>217</sup> This omission may imply that a derivative lawsuit is the preferred action against a PBC's directors for failing to pursue a public benefit.<sup>218</sup>

Finally, the Delaware statute explicitly provides protections for directors where directors are assumed to meet their fiduciary duties, and allows for PBCs to have a § 102(b)(7) exculpation clause "eliminating or limiting the personal liability of a director to the corporation" concerning the directors' good faith obligation.<sup>219</sup>

### 3. *Evaluating the Model Legislation and Delaware approaches, and deciding which approach EMOs should adopt*

Like all legislation, benefit corporation statutes are imperfect. They are also still in their infancy.<sup>220</sup> As of May 2016, no plaintiff has brought a lawsuit to force a benefit corporation or PBC to pursue its stated public benefit. There is no case law concerning these new entities. However, in evaluating which approach EMOs should choose, it is important to keep in mind the purpose for which EMOs should become benefit corporations. The primary reason is neither puffery nor to make empty promises about avoiding financial mismanagement. It is to create positive branding that states can rely on when deciding whether to allow EMOs to continue operating. In essence, benefit corporation branding would signal to a state that the EMO is committed to providing charter schools with expertise and economic savings to improve student body education. It would allow the EMO to

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<sup>216</sup> *Id.*

<sup>217</sup> See Tu, *supra* note 160 and accompanying text.

<sup>218</sup> Plerhoples, *supra* note 190, at 257.

<sup>219</sup> DEL. CODE ANN. tit. 8, § 365(c) (2013).

<sup>220</sup> Sean W. Brownridge, *Canning Plum Organics: The Avant-Garde Campbell Soup Company Acquisition and Delaware Public Benefit Corporations Wandering Reulon-Land*, 39 DEL. J. CORP. L. 703, 711 (2015) Maryland and Vermont were the first states to pass benefit corporation legislation in 2010. *Id.*

acknowledge that it wants to make a profit, while agreeing not to do so to the charter school's financial detriment.

In terms of increasing EMO accountability, the Model Legislation's approach to annual reporting that is posted on the public portion of the benefit corporation's website is more robust than Delaware's biennial requirement. Delaware's approach means that two years pass before shareholders or the state would know whether the PBC had fulfilled its specific public benefit, and this diminishes the increased accountability intent behind the Model Legislation.<sup>221</sup> However, the Model Legislation's reporting requirement is not without its weaknesses. The Model Legislation's requirements for annual reports are vague and have resulted in benefit corporations releasing annual reports that are nebulous and seem more like marketing materials than complete, fair evaluations of the benefit corporation's progress.<sup>222</sup> The Model Legislation also lacks an effectual enforcement method for corporations that do not follow the reporting requirement.<sup>223</sup> As such, the annual report requirement could be improved by requiring benefit corporations to disclose specific information tied to their performance via an effective enforcement method. However, between the two, the Model Legislation's approach sets a higher benchmark for annual reporting, which would benefit EMOs in terms of increasing accountability and effective branding.

The Model Legislation's third-party standard requirement is also a better option with regard to improving EMO accountability to investors and states. Under Delaware's statute, the lack of a third-party standard may lead to directors choosing easy requirements to measure their work against.<sup>224</sup> EMOs can increase the states' trust by choosing a reasonable third-party standard for evaluating the corporation's annual report, as the Model Legislation does not specify the type of third-party standard benefit corporations should choose. The mistake that some EMOs may make is choosing a lax third-

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<sup>221</sup> Murray, *supra* note 207, at 360–61.

<sup>222</sup> *Id.* But see ANNUAL BENEFIT CORPORATION REPORT, PATAGONIA WORKS (2013), [http://www.patagonia.com/pdf/en\\_US/bcorp\\_annual\\_report\\_2014.pdf](http://www.patagonia.com/pdf/en_US/bcorp_annual_report_2014.pdf) (This is an outstanding forty-three page benefit corporation report that goes into detail on the corporation's progress towards fulfilling their general and specific stated public benefits).

<sup>223</sup> Murray, *supra* note 207, at 360.

<sup>224</sup> Hasler, *supra* note 182, at 1321.

party standard. However, this would be detrimental to the branding purpose and would not be advisable.<sup>225</sup> Thus the Model Legislation's third-party standard requirement could be improved by setting out some minimum standards put in place by a select few well-established third-party organizations that a benefit corporation would need to consider when choosing a third-party standard to evaluate its annual report against.<sup>226</sup>

Delaware's requirement that PBCs state a specific public benefit is actually more stringent than the Model Legislation's general public benefit requirement. In this regard, Delaware's approach would be more advisable for an EMO.<sup>227</sup> By requiring an EMO to focus on a specific public purpose, it is more likely to pursue that purpose. Directors would more easily recognize the EMO's objective, thus improving accountability.<sup>228</sup> Even though the specific public purpose provision is not required under the model approach, an EMO benefit corporation in a state that follows the Model Legislation can still specify a specific public benefit that it wants to pursue in conjunction with the mandatory general public benefit.<sup>229</sup>

There are some lingering questions regarding benefit corporation legislation in general that EMOs will want to keep in mind when deciding whether to move forward with becoming benefit corporations. First, there is no case law regarding how a court will assess a benefit corporation's balancing of various stakeholders if a plaintiff brings an enforcement action against the corporation.<sup>230</sup> EMOs may find this uncertainty unappealing and they may wait until an enforcement proceeding has gone through a court to see what the court does. Second, the overall lack of enforcement mechanisms other than the vague shareholder enforcement action under the Model Legislation makes it difficult to ensure compliance or to discern further corporate exploitation.<sup>231</sup> Third, the Model Approach

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<sup>225</sup> Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, 62 EMORY L.J. 681, 725 (2013).

<sup>226</sup> Kimbrell, *supra* note 168, at 581.

<sup>227</sup> DEL. CODE ANN. tit. 8, § 365(a) (2013).

<sup>228</sup> J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 27, 33 (2012).

<sup>229</sup> MODEL BENEFIT CORP. LEGIS. § 102 (2016).

<sup>230</sup> Ercoline, *supra* note 188, at 183. (However, "legal scholars commonly agree that the courts will apply the traditional business judgment rule in benefit enforcement proceedings when evaluating the Board of Director's decision-making process.")

<sup>231</sup> Kennan Khatib, *The Harms of the Benefit Corporation*, 65 AM. U. L. REV. 151,

requires benefit corporations to consider their impact on society *and* the environment.<sup>232</sup> It is unclear how courts will interpret this provision and whether the lack of an equivalent environmental purpose could create a legal issue for a benefit corporation, as would be the case with EMOs.<sup>233</sup> It is hard to believe that benefit corporation legislation was intended only for use by businesses whose primary focus is benefitting the environment, thus EMOs could argue that their environmental benefit is having a positive material impact on surrounding communities by improving K–12 education.<sup>234</sup> However, it remains to be seen how broadly courts will read the “environment” language.

Finally, stakeholders other than shareholders do not have standing to bring enforcement proceedings.<sup>235</sup> This is problematic because the people most likely to be negatively affected by a benefit corporation’s decisions are groups like employees and those living in surrounding areas who do not have standing to bring enforcement actions. In the case of EMOs, the groups most affected by an EMO’s failure to follow through on its public purpose would be the students and parents as well as charter school operators. However, given the difficulty that a court would have in discerning who constitutes a stakeholder whose interest the benefit corporation must balance, it is understandable that the legislation left enforcement proceedings to shareholders as a discernable group. Shareholders who invest in an EMO benefit corporation likely have the stakeholder’s interests at heart. If a shareholder who has standing to bring an enforcement proceeding observes the EMO failing to fulfill its public benefit, he or she can instigate an enforcement proceeding in the interest of the stakeholders.

Overall, it would be in an EMO’s best interest to choose a state that follows the Model Legislation more closely than Delaware. It may seem counterintuitive to become a benefit corporation in a state other than Delaware, as most states look

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189 (2015).

<sup>232</sup> Katherine R. Lofft, *Is A Hybrid Just What the Doctor Ordered? Evaluating the Potential Use of Alternative Company Structures by Healthcare Enterprises*, 25 A.B.A. HEALTH LAW. 9, 12 (2013).

<sup>233</sup> *Id.*

<sup>234</sup> *Id.*

<sup>235</sup> MODEL BENEFIT CORP. LEGIS. § 301(c) (2016).

to Delaware on corporate law matters.<sup>236</sup> However, their lax attitude towards benefit corporation legislation is actually detrimental to the social enterprise movement, as it renders the legislation essentially toothless; many of the requirements that make the Model Legislation powerful are optional under Delaware law.<sup>237</sup> If a business, such as an EMO, is trying to send a message via their branding that they are serious about pursuing a social good as well as making profits, then it would be wise for EMOs to consider becoming benefit corporations in a state that follows the Model Legislation more closely than the hands-off Delaware approach.

### *C. Why Should EMOs Ultimately Choose to be Benefit Corporations?*

EMOs should choose to become benefit corporations primarily for branding purposes in order to regain the trust of state legislatures and to prevent further bans on EMO-charter school partnerships.<sup>238</sup> The Model Legislation's benefit enforcement proceeding gives shareholders more power to bring an action for the corporation's failure to consider the interests of various stakeholders.<sup>239</sup> Restricting the remedy to an equitable (rather than monetary) one ensures that plaintiffs will begin such proceedings solely to align the director's actions with the corporation's stated public benefit, thus increasing accountability and state trust in EMOs.<sup>240</sup> The presence of a third-party standard requirement for assessing the benefit corporation's business decisions would also strengthen the trust between EMOs and states.

EMOs may be concerned that becoming benefit corporations would scare away investors. These fears are likely unfounded. Investing in social enterprises, known as "impact investing," is

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<sup>236</sup> Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 889 (1990) ("Because of Delaware's market dominance, the General Corporation Law of Delaware controls the internal affairs of thousands of corporations, including more than half of the 500 largest industrial firms in the United States."); Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 195 (2011) ("In the competition for corporate charters, Delaware has since the beginning of the twentieth century stood alone as the decisive winner.").

<sup>237</sup> See *supra* note 206 and accompanying text.

<sup>238</sup> Murray, *supra* note 228, at 44.

<sup>239</sup> MODEL BENEFIT CORP. LEGIS. § 301 (2016).

<sup>240</sup> Thornsberry, *supra* note 153, at 180–81.

becoming a more frequent occurrence.<sup>241</sup> In a J.P. Morgan study examining social enterprise investing, researchers found that impact investing offers potential over the next ten years for invested capital of between \$400 billion and \$1 trillion with profits of \$183 billion to \$667 billion.<sup>242</sup> From 2010 to 2012, sustainable and responsible investing had a growth rate of over 22%, and this growth has continued.<sup>243</sup> Generating positive change motivates investors who invest capital in social enterprises.<sup>244</sup> Those same investors reject the “binary” approach that their investments can either maximize their return or maximize a social impact.<sup>245</sup> Social enterprise investing is poised to become a common sector of a diversified portfolio, allowing people to make “feel good” investments without worrying that they have to give up substantial profits to do so.<sup>246</sup> Further, customers are expressing a greater interest in services from corporations that take into account their societal and environmental impacts. Consumer surveys show 58% of American consumers are more likely to purchase products from a socially conscientious company.<sup>247</sup> Thus given the recent trend in social impact investing, EMOs will likely not have too much trouble finding investors or charter schools as customers.

EMOs branding themselves as benefit corporations would also have the positive effect of attracting charter schools with whom EMOs can contract, as they are more likely to trust EMOs whose stated purpose is to advance charter school goals when they are shopping around for a business to partner with.<sup>248</sup> If an EMO can attract enough charter schools through benefit corporation branding, then the EMO will be able to scale its model and attract investors who are interested in

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<sup>241</sup> NICK O'DONOHUE, J.P. MORGAN, IMPACT INVESTMENTS: AN EMERGING ASSET CLASS 1, 7 (2010), <https://thegiin.org/assets/documents/Impact%20Investments%20an%20Emerging%20Asset%20Class2.pdf> (“Impact investments are investments intended to create positive impact beyond financial return.”).

<sup>242</sup> *Id.* at 6.

<sup>243</sup> *Id.*

<sup>244</sup> Deborah J. Walker, *Please Welcome the Minnesota Public Benefit Corporation*, 11 U. ST. THOMAS L.J. 151, 180 (2013).

<sup>245</sup> *Id.*

<sup>246</sup> *Id.*

<sup>247</sup> *Id.* at 153.

<sup>248</sup> Hasler, *supra* note 182, at 1321–22.

double- or triple-bottom line investments.<sup>249</sup>

## V. CONCLUSION

Contrary to Gordon Gekko's speech in *Wall Street*, greed is not the way forward for EMOs. Several financial events over the past decade have left Americans dissatisfied with the current state of corporations—most notably, the 2008 subprime mortgage crisis.<sup>250</sup> Now, consumers and investors are becoming more cognizant of the businesses that they choose to support.<sup>251</sup> It is wishful thinking to believe that, left to their own devices, all EMOs can operate without misusing public funding. Repeated instances of financial mismanagement by EMOs have shown that some EMOs cannot act in a socially responsible manner. In a bid for survival, EMOs will need to choose between two alternatives. They can continue to operate under their current business model, and risk that a few dishonest EMOs will justify states banning all EMOs from partnering with nonprofit charter schools or risk that the states will institute onerous regulations that result in EMOs no longer being able to operate in those states.<sup>252</sup> Such responses will result in a huge loss in EMO profits.

The second alternative is benefit-corporation branding. By choosing to become benefit corporations, EMOs that truly want to pursue the dual purpose of improving charter school education and profiting at the same time can separate themselves from those EMOs that exist to increase their profits at the expense of charter schools. If they do, states may be less likely to react to the few disingenuous EMOs with a state-wide ban on EMOs.

EMO greed can and has caused entire states to ban EMOs.

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<sup>249</sup> *Id.*; Thornsberry, *supra* note 153, at 185.

<sup>250</sup> Brett J. Travers, *Why Reinvent the Wheel?—Protecting Consumers in the Wake of the Subprime Mortgage Meltdown without the Consumer Financial Protection Bureau*, 55 ST. LOUIS U. L.J. 457 (2010).

<sup>251</sup> Thornsberry, *supra* note 153, at 188.

<sup>252</sup> See Dixon, *supra* note 141; see also MASS. GEN. LAWS ANN. ch. 71, § 89 (West 2014) (requiring an exhaustive list of requirements a charter school must meet in order for the Massachusetts Board of Education to approve an EMO-charter school contract). The requirements include: charter applicants explaining how they chose the EMO and vetted it, as well as providing evidence that the EMO has a record of positive academic success with charter schools. As a result of these stringent requirements, there are only two EMOs in Massachusetts, and they manage only two of the sixty-two charter schools in the state. *Id.*



EMO greed has damaged their reputation as well as the reputations of the charter schools with whom they contracted. EMO greed has detracted from the charter school movement as a whole, which is a movement that has the potential to make many positive changes for children with otherwise limited possibilities. Benefit corporation status would enable EMOs to fulfill their mission. They can continue to help charter schools, make a personal profit, and regain the trust of states that are about to pull the trigger on legislation that outlaws EMO operations completely.

*James Eastman\**

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\* J.D. Candidate, (2017), The University of Texas School of Law; B.A., (2011) Austin College. This paper is dedicated to the memory of Professor Loftus C. Carson II who suggested the topic of this Note and who was always available to provide guidance throughout the writing process. I am also indebted to the members of the BYU Education and Law Journal for their essential substantive recommendations and editing assistance. And finally, I would like to thank my father and mother for their love and never-ending support.